

SERBIA AND MONTENEGRO
SMALL AND MEDIUM ENTERPRISES, AGRICULTURE
AND MICROFINANCE ASSESSMENT

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March, 2005

INTRODUCTION

The purpose of this assessment was: to review the evaluate the environment for microenterprises and SMEs in Serbia an Montenegro; to identify key constraints to growth; to examine activities being carried out by USAID and other donors in order to identify programmatic gaps; to learn how USAID/s existing activities could be better focused to meet the needs of the small enterprise sector; and to determine whether enterprises working in the agriculture sector have unique needs that require a different approach. This assessment was conducted during three weeks in March, 2005, in which a three member team from USAID/Washington, Economic Growth, Agriculture and Trade Bureau traveled to several parts of the country and talked with representatives from the private sector, the government, donor and non-governmental organizations as well as USAID implementers and partners

This report is divided into two main sections, one for Serbia and the other for Montenegro. Each section is further divided into background, findings, conclusions and recommendations. We hope this report will be useful to the Mission.

SERBIA

BACKGROUND

The government's "Strategy for the Development of Small and Medium-sized Enterprises and Entrepreneurship in the Republic of Serbia, 2003-2007" has two priority targets for the development of the SME sector by the end of 2007:

- Increase the total number of SMEs (sole traders and limited companies) from 270,000 (2002 total) to 400,000 and
- The creation of over one million net new jobs in the SME sector.

These are ambitious objectives. As the following table from the World Bank report titled, Republic of Serbia: An Agenda for Economic Growth and Employment, dated December 6, 2004 shows, the GoS has a considerable distance to go to meet these objectives. The growth of SMEs in Serbia over the years from 2000 to 2003 shows average growth of about 7500 newly registered SMEs per year. Of those registered SMEs, the number of active SMEs in only about 28% of those registered. It would appear that the GoS will not be able to attain its objectives unless major changes are made to increase the number of SMEs and workers in the next few years of this strategy.

Table 4.3: Evolution of Serbia's SME sector, 2000-2003

	2000		2001		2002		2003	
	Number	Workers	Number	Workers	Number	Workers	Number	Workers

Number of registered SMEs	216780		223796		234027		239270	
Number of active SMEs	61722	610619	63985	581193	66219	654768	67703	669442
Number of shops	176724	353448	188812	377624	195186	390372	207596	415192

Source: SME Agency and Solvency Center (cited in World Bank Report No. 29258-YU, Dec. 6, 2004)

The same World Bank report cites (on pages 73-74) the following key areas that are in need of improvement and on which the GoS could have substantial impact if it took actions to address these problems. Note that these problems impact both SMEs and microenterprises.

4.34 A synthesis of numerous information sources reveals several particularly problematic aspects of Serbia's business enabling environment, both from the perspective of the Serbian business community, and from comparisons of Serbia to other countries. These sources include the noted and other firm-level surveys, expert analyses such as the ICA and "Cost of Doing Business", and discussions and meetings with representatives of the Serbian private sector. Notwithstanding the legislative changes undertaken by the government, major weaknesses remain in the following key areas:

- **Contract enforcement.** Serbia is characterized by weak contract enforcement in courts (with weak judicial capacity increasing the case backlog), and an evident pro-debtor bias incorporated in the legislation. As a result, firms tend to use courts only as a last resort. This also makes firms less willing to deal with new customers and suppliers, thus resulting in fewer transactions. Combined with the inability of the courts to resolve disputes effectively, the legislation has led to uncertainty and confusion and provided a fertile ground for corruption. The difficulty of enforcing contracts also encourages informal activity, as a firm gains little from registering its business activity. [Note – the USAID CCASA activity is addressing many of these issues and appears to be making progress]

- **Access to finance.** Poor access to credit forces businesses to rely on their own sources of capital – either internal funds and retained earnings or money borrowed from friends and family. The lack of credit combined with the institutional uncertainties and political risks provides strong incentives to stay at least partly informal and short-term oriented. Therefore, making the legal and institutional environment more conducive to greater intermediation represents the key to establish financial system capable of delivering an adequate range of credit and other financial services to the enterprise sector, and especially to its expanding SME component that will represent a major contribution to real sector growth and employment generation.

- ***Regulatory burden.*** The overall cost of compliance with regulatory norms, as well as the predictability of the business rules, and the fairness in their application represent serious problems in Serbia. The process often involves corruption and a high degree of inconsistency in the application of the rules, with public servants having wide discretionary powers in making decisions on minor issues that affect the issuance of permits, licenses and certificates. [Note, the USAID EPEE activity is addressing these issues]

- ***Access to land and formalization of real property.*** Secure ownership and the ability to exchange land are critical for the investment climate particularly for foreign investments. Restrictions on land use and pervasive state ownership and control of urban land (particularly land that is open for construction) are major issues for the construction and services sector. In addition, the unresolved issue of restitution continues to create uncertainty and deter many real estate and other investors. Finally, the Serbian land administration system is in a poor state. In addition to almost 80 percent of apartments not being registered, the burdensome construction permitting procedures deserve the attention of the authorities.

4.35 All of these weaknesses lead to high transaction costs that also contribute to the significant and lingering presence of the informal economy.

A number of interviewees for this assessment remarked on the need to privatize many of the SMEs that are still state or socially-owned enterprises. These enterprises compete unfairly with many of the private sector enterprises and are a hindrance to the growth of the private sector. The capacity for the growth and expansion of private sector SMEs, including microenterprises, is considerable, but unfair competition from state and socially-owned enterprises are a significant constraint on that growth. In addition, Serbian SMEs must learn how to compete in the global economy if they are to succeed. This is true not only in regard to exports of Serbian products and services to regional or European markets, but in order to compete with imported products and services in Serbian markets as well.

This means that the capacity for Serbian privately-owned SMEs to provide competitive products and services is considerable; however, the constraints mentioned above must be overcome if that capacity is to improve.

FINDINGS

Policy/Regulatory Environment

- Privatization appears to be on the fast track for the upcoming two years

An interview with Mr. Miodrag Djordjevic, Director of the Serbia Privatization Agency, revealed that, although privatizations had stalled the past couple of years, plans are underway to offer a minimum of 300 firms (mainly SMEs) for sale in 2005. Larger companies (1500 – 2000 employees) are sold via a tender process, while SMEs are sold in share packages. Many of the companies will have been prepared for sale through a restructuring process. The current law on privatizations states that all privatizations should be complete by 2007, although it previously stated that they should be complete by 2005. There are approximately 80 companies that work in the textile sector. A large number of companies are in the agriculture sector. Many of these are farm cooperatives, but have an uncertain legal status. A new law is expected to clarify the legal status of farm coops so that they can be sold. However, there are many problems related to land title and restitution that the government will have to resolve prior to the privatization of many agriculture-related companies. State-owned land cannot currently be privatized, so long-term leases are the only option for those, at the moment. Much of the land in Vojvodina was expropriated from individuals during the Communist era and it will be difficult to sell that land to third parties until the issue of restitution is resolved.

Mr. Boris Begovic, Vice President of the Center for Liberal-Democratic Studies, who has organized workshops for USAID on SME-related issues, stated that about 69 firms that employ approximately 155,000 people are critical to making the privatization process significant. He understands that the government seems to be moving forward this year toward privatizing many of the existing state-owned firms.

- Legal reform is proceeding very slowly and the court system still requires major reform and restructuring (being addressed by the CCASA project)

A meeting with Milo Stevanovich, Chief of Party, USAID Commercial Court Administration Strengthening Activity (CCASA), revealed that substantial restructuring of the commercial court system is necessary along with extensive training and physical forms of support (better court facilities, computers, etc.) being provided by CCASA. This is a three year project funded at \$12.8 million and is working with 17 commercial courts throughout the country. In sum, although progress is being made on the court system, other forms of legal reform are necessary (land title, privatization issues, improvements in collateral law, etc.) and it will be a few years before the legal and court structure in Serbia will be consistent with European norms.

Patricia Gannon, an attorney at Karanovic & Nikolic who also serves as legal advisor to the Foreign Investors' Council (FIC), said that some progress is being made on the legal reform process vis-à-vis business registration and some other areas but much remains to be done. She mentioned problems in government

regulation (too many inspections, bribes, etc.), transparency in government procurement, and that the government needs to figure out how to reward those businesses that operate legally, rather than punish them. In other words, the incentives to operate legally do not yet outweigh the incentives to operate in the informal sector. Until this incentive system issue is resolved, more SMEs will find ways to avoid the law, rather than complying with it. She thought that it could be useful to promote more study tours to other countries in Eastern Europe so that Serbian entrepreneurs can see how other countries have successfully dealt with the same problems that currently exist with the legal and regulatory system in Serbia.

- Public/private sector dialogue on reforms has shown some improvement at the national level and at a few municipalities, but much work remains to be done

The Foreign Investors Council (FIC) and American Chamber of Commerce (Amcham) have both been active in promoting public/private sector dialogue. The FIC presented their second annual White Paper on government policies toward foreign investment and the general business environment during the Team's visit to Serbia and the presentation was attended by Team members. The Deputy Prime Minister spoke at the presentation and indicated the GOS's interest in improving the environment for business and Foreign Direct Investment (FDI). Business associations composed of Serbian businesses appear to be very few and not very effective. The Community Revitalization through Democratic Action (CRDA) has worked with local business associations and may be in a better position to evaluate their prospects. The Serbian Enterprise Development Project (SEDP) has helped to organize the businesses in the specific sectors in which they work, but one senses that they are not yet sufficiently organized to have much of an impact on government policy.

An SME Advisory Board (SMEAB) was established in 2001 by the GOS as part of its Strategy for the Development of SMEs and Entrepreneurship for 2003-2008, but there is little evidence that it has any effectiveness in promoting the interests of SMEs in Serbia. The SME strategy seems more focused on government support to the SME sector than working to establish a dialogue with private sector businesses.

- The continued lack of transparency in government institutions provides opportunities for corruption and abuse.

Many persons interviewed mentioned this lack of transparency in business registration, land title and tax enforcement. This is a common problem amongst countries in the FSU and its orbit. Some countries, such as those in the northern tier of Central Europe have made considerable progress, but much work remains to be done in the southern tier to bring them up to standards existing in Western Europe and the U.S.

- Think tanks are at a nascent stage with some prospects for growth and increased usage for public/private sector dialogue

The Assessment Team met with a few of the think tanks in Serbia, all of which are concentrated in Belgrade. Compared to some neighboring countries, such as Bulgaria, the Serbian think tanks are still very small with limited funding and staffing. The Jefferson Institute, a local think tank with a representative office in the U.S., conducted a study on competitiveness of the Serbian economy in 2003 financed by the National Bank of Serbia. This will be updated in 2005 with financing by the Ministry of Finance and will be coordinated with the SEDP Project. They also have conducted sector and regional specific studies. The Center for Liberal-Democratic Studies conducted some workshops for USAID on SME-related matters and prepared a report on issues raised during those workshops. The Center for Advanced Economic Studies is a newly founded think tank run by Kori Udovicki, former governor of the Central Bank and Minister of Energy, out of the University of Serbia and has potential for support from USAID to develop its capacity for research on macroeconomic issues.

- Forward looking agricultural laws have been put in place and an agriculture strategy is being drafted

The Ministry of Agriculture has drafted a very progressive agricultural strategy that has three major elements: completing the transition from socialism to a full market economy; integration with and ultimately accession to the European Union; and a radical restructuring and modernization of the whole agriculture sector. The ministry is reducing its role in many areas such as providing agricultural production subsidies, providing inputs and credit and operating directly in commodity markets. At the same time it is taking on new functions to ensure that the market works well such as providing market information services to support private sector development and services to ensure compliance with international health and safety standards. It has a clear objective to decouple support from production by eliminating production-increasing subsidies. One objective of the new strategy is to meet the agricultural standards required to join the WTO and the EU. This means being competitive so that Serbian agriculture can compete with imports and even compete in export markets. While much remains to be done, the strategy is a positive sign that the Ministry is serious about improving the role of agriculture in the Serbian economy.

Finance

- Government is supporting too many subsidized credit programs that compete with credit programs that exemplify best practices.

Interviews with a consultant from the Springfield Centre in Britain who was in Belgrade revealed that the government is currently providing subsidized credit through a number of schemes and other subsidized credit programs are in the planning stage. Since subsidized credit distorts the market for best practices credit programs such as those of ProCredit Bank and Opportunity International, the GOS should be encouraged to provide grants and

subsidies for services, such as training and market information, rather than start-up credit for businesses.

- While credit supply is increasing, there is a shortage of equity capital

Procredit Bank is a full-fledged bank established with financing from the EBRD. It has been expanding its operations over the past few years and currently has a portfolio of about Euro 20 million with about 20% of the portfolio in agriculture production. Average loan size is Euro 2,700. Procredit has just formed a leasing company and plans to commence operations in the next few months. Opportunity International's program, financed by USAID, is focused on the Novi Sad area but has been expanding to other parts of Serbia over the past 2 years. It currently has 5 branches and plans to create more in the south of Serbia. Its portfolio is currently Euro 3.8 million and provides loans in 3 categories: micro loans up to Euro 5,000 (Euro 2.6 million of their loans are in this category), small business loans ranging from Euro 5-10,000, and business development loans ranging from Euro 10,000-100,000. Opportunity International does not yet operate as a full-fledged bank because it is awaiting the passage of a new banking law which would allow OI to become a full-fledged bank.

The Serbia and Montenegro Export Credit Agency (SMECA) was established as a World Bank implementation unit in early 2003, but was not effective operationally until August 2004. It is capitalized at Euro 20 million and is owned by the Government of Serbia and Montenegro and functions as an Export-Import Bank. Its principal function is to offer financial assistance to Serbian and Montenegrin exporters. It provides export credit through short-term working capital loans at about 8% interest for pre-shipment expenses. It also provides export guarantees and insurance. It is meant to serve clients who cannot obtain bank financing and has a ceiling of Euro 1 million per client. While SMECA is not focused on SMEs, they are the principal clients of SMECA. SMECA is not focused on any particular sectors. The Team was informed that exporters previously financed export transactions during sanctions via informal sources at about 18% interest. That rate is now down to about 9% and informal sources are now providing competition with SMECA since the informal lenders do not require as many assurances as SMECA.

- Government subsidized credit programs are providing credit to start-up businesses and vulnerable individuals/groups, but it is not clear how these are impacting credit programs through institutions utilizing best practices

The team was not aware of any studies of credit programs for SMEs in Serbia, so there is no data on the impact of government subsidized credit on programs such as ProCredit Bank and Opportunity International. However, due to the demand shown for loans from ProCredit and Opportunity, it appears that there is still substantial unmet demand for credit so the subsidized credit programs have not yet begun to impact on those programs. If the government continues to offer subsidized credit, those programs may eventually limit the long-term financial viability of the non-subsidized programs. This would be most unfortunate since it would create a long-term dependency upon subsidies from the government which may not always exist.

- Commercial banks provide less than 3% of all enterprise related working capital, less than 3% of all working capital, and 5% of supplier credit.

Although the increase in competition has pushed down costs for SME credit, they are still high by regional standards. The going rate for non-subsidized SME loans is 20 to 30% per annum. While this is partly driven by the scarcity of capital, it is predominantly due to the low level of competitiveness of the financial sector and the perception of high political and macroeconomic risks present in Serbia.

- Discussions with credit providers revealed increased competition for SME loans and consequent reduction of interest rates, but the high demand for consumer credit makes it difficult to determine the actual use of credit for enterprise development

Both ProCredit and Opportunity mentioned how increased competition is driving their interest rates down for SME lending. It was not clear if the competition is coming from other unsubsidized sources or from government subsidized programs

- FDI is low compared to other countries due to perceived risks of investors based on policies and politics.

The difficulties in the business climate for FDI are well known and detailed in the FIC White Paper. The country continues to suffer from a relatively unstable political climate, which impacts on the economy. The Trade Assessment notes some of the items that make Serbian a less attractive country for FDI and this assessment agrees with those assertions.

- The National Bank imposes an 18% reserve requirement and a 20% revenue tax (note, not profit). The reserve requirement reduces the funds that the banks can lend out of their total capital. The National Bank requires all lending with less than a five year term to have a corresponding 25% provision, unless the client places 20% of the loan on deposit with the institution.

Microfinance

Background

The Microfinance sector in Serbia is composed of NGOs that evolved predominantly from the relief operations of a variety of donors, and corporate entities that were started from greenfield donor investments. MDF and Agroinvest were both involved in the donor-driven relief operations as their original primary purpose. By contrast, ProCredit and Opportunity Banks were donor initiated institutions with primary mandates to lend to small and micro enterprises.

The NGOs have successfully overcome significant challenge of transitioning from a relief-oriented, subsidized operation to that of market-based, sustainable financial institutions.

As a result of donor mandates, the four institutions provide broad geographic and sectoral coverage in Serbia. The NGO institutions remain committed to servicing a more disadvantaged client base and, by contrast, ProCredit and Opportunity Bank have identified substantial opportunity in the agricultural small enterprise sectors and the growth of their lending in those areas reflects this growing interest.

This diversity provides the Mission with a useful balance in geographic and enterprise coverage. The shape of the future program can be used to select which, if any, institutions could most effectively support achieving mission enterprise development objectives.

The first element of this assessment examined the governance structure of each institution. As a result of a determination that **MicroFins** continues to suffer from governance issues which impact its growth and operations, it was not included in further institutional analyses.

Legal Framework

While the current legal framework does not permit the direct operation of microfinance institutions, the current banking framework provides sufficient flexibility for NGOs to provide financial services effectively to micro and small enterprises. In addition, the banking law has permitted the introduction of two formal institutions that have a primary or secondary focus on micro and small loans. A new banking law is currently in development that will be harmonized with EU directives and Basel core principles for effective banking. It is not clear yet how this will affect microfinance institutions.

There are two structures for microfinance in Serbia to adapt to the current legal framework. In the first instance, adopted by MDF, the NGO places funds with a commercial bank, which then disburses funds as the NGO approves loans. The commercial bank is paid a fee for its management of the “back office” operations, and for disbursing loans and receiving loan payments. This actually can be advantageous to certain operations since it alleviates the MF institutions from developing cash management functions.

In the second instance, utilized by Agroinvest, a guarantor/deposit model is utilized. Agroinvest deposits its funds into a guarantor account operated by the bank. In this model, the bank is actually the lender, and Agroinvest guarantees the credits issued by the bank, and acts as a technical advisor for the bank in approving the loan.

Microfinance Institutions

Agroinvest

AgroInvest is a World Vision network institution. It was started by World Vision and is now an independent organization with operations in both Serbia and Montenegro. Interestingly, it has a unified management structure for both countries, but distinct legal status in each country depending upon the legal framework.

Ninety-three percent of its portfolio is based on agriculture, and its loan size (250 – 3500 EUR) is among the lowest of the Serbian microfinance institutions. The average loan term is 18 months to accommodate the agricultural cycle. It currently reaches over 13000 clients, and has a single loan product whose terms include: 20% interest, up to six months grace (suits agricultural cycle), and a 3-30 month term.

Agroinvest uses the village council as an informal community body that approves loans and interacts with borrowers. In this way it leverages an existing social structure for its loan operations and has been highly effective. Growth has been over 30% annually.

The Agroinvest model of providing a six month grace period provides its product with a unique position in the credit marketplace for agricultural lending.

MDF

MDF began operations in 2001 and the portfolio has grown from 641 loans to 2100 loans today. As such, MDF still has a small portfolio, but it is leveraging the broad geographic coverage of its former relief program to develop well-diversified program coverage. It currently has 1 head office in Belgrade, 3 regional offices in Kraljevo, Nis, and Uzice, and 5 branch offices in Cacak, Nova Varos, V. Banja, Jagodina, and Kragujevac

MDF has recently made significant investments in its managerial infrastructure and is well poised for future growth. It plans to grow its portfolio to 8000 loans by 2008. While its current portfolio at risk is still low at 4% by international standards, it is high in comparison to other institutions in Serbia. While 8000 loans is still not a very significant portfolio, MDF should be able to leverage its infrastructure to continue that growth for a number of years. Therefore, it might be well positioned to be an effective Mission partner.

MDF also manages an innovative vocational education model which has a high degree of success in placing trained people in permanent jobs (although the absolute numbers of those trained are somewhat low). While MDF has had good evaluations of its management, the insistence of the institution on maintaining this program could pose a distraction to the overall institutional focus in developing the microfinance operations.

MDF has developed innovative partnerships with progressive municipalities (Kragovitz and Chachek). This model might provide a useful framework for future Mission

programming that merges municipal and enterprise level programs.

ProCredit Bank

ProCredit targets a broad spectrum of loan products and markets, ranging from agriculture to trade to industry to services. The portfolio is relatively equally divided among the different target markets, even though the agricultural loan product was introduced in mid-2003. ProCredit covers about 85% of the country through 28 branches and outlets in 18 cities.

ProCredit does not require collateralization for loans of less than 5000 euro. Almost half of the business loan portfolio is for less than 5000 euro and this proportion is increasing as the average loan size for the institution is dropping. ProCredit also offers larger loans and about 20% of the total portfolio is for loans of over 100,000 euro. The institution has been successful in developing a broad portfolio of credit products and is actively assessing the business environment to identify new opportunities.

ProCredit brings a substantial level of international experience to bear in developing its Serbia operation and has a significant financial commitment to expand the reach and depth of its operations. It may be a useful Mission partner in developing more sophisticated financial products designed to reach niche markets that are the focus of other Mission programs. However, the institution is well-capitalized and would probably only do so if it were perceived to be within the strategic interests of the institution.

Opportunity Bank

Opportunity Stedonica was awarded a ten million dollar follow-on grant with USAID in 2003 to become a fully registered bank, obtain more formal premises, expand SME lending and develop a mortgage product. While the mortgage product has not proved feasible, the bank has improved its premises and is in the process of becoming a commercial bank. Discussion with Opportunity indicated that the success of this planned transition would require a change in the law. The new banking law that is in development reportedly will contain provisions for the conversion of Opportunity Stedonica into a full-fledged and licensed bank.

Opportunity has been slow to increase the size of their portfolio, indicating that this delay was due, in part, to their current legal status as a "Savings and Loan" which precluded access to other sources of capital. Opportunity has vigorously sought approval from the NBS to raise debt and has been rejected on a number of occasions. It plans to utilize the funds under its new USAID grant to grow its portfolio and to focus its operation towards the SME market and towards the South. Opportunity acknowledges that it will compete with a number of other financial institutions already in that market segment and has set out a strategy to target SMEs that are in underserved regions or sectors. The OI reports that its strategy is and always has been to try and reach those who have difficulty in accessing finance from conventional providers and it believes they are continuing to do this, for example with existing micro clients who are starting to grow.

Opportunity's 5 year plan shows significant increases in Micro lending by value and number of clients. They would only be able to achieve this as a bank, which in turn requires enactment of the new banking law. A bank license will enable OI to attract other investors (OI reported that they estimate they could raise an additional \$15 million once they are able to become a licensed bank) and gain a wider variety of clients to enable this growth.

Nevertheless, Opportunity will continue to include microlending in its portfolio and projects that in 2009 it will have 17000 micro loans outstanding and over 5000 SME and business loans. By value, SME and business loans will compose over two-thirds of the total portfolio. Of the current grant with USAID, 2 million EUR will be devoted to SME lending and just over 4 million EUR will be devoted to micro loans.

The original grant directed Opportunity to target South Serbia, and 6% of loans and just fewer than three percent of the value of the portfolio is in that region. Under the new grant amendment currently under negotiation with USAID, Opportunity Bank will engage in a significant expansion strategy to increase dramatically the institution's presence in southern Serbia with new branches in Krusevac, Leskovac, Vranje, Pirot, Kraljevo, and Novi Pazar.

Findings

- While there is increased competition in providing financial services to SMEs there is no corollary in the provision of credit to microenterprises. The market is large and continues to be substantially underserved.
- Serbian institutional portfolios still include fewer than 50,000 active microenterprise loans. While this may appear substantial, the market for microfinance lending in Serbia has been estimated to be between 1.5 and 3 million loans.
- Several solid microfinance institutions in Serbia are at least operationally sustainable (revenues are sufficient to cover operational costs). Micro Development Fund (MDF), Agroinvest, ProCredit and Opportunity Bank have all integrated best practices into their operations, are well managed, and have invested in training and infrastructure to prepare themselves for accelerated growth in the future.
- The EBRD and KfW have begun to work with formal banks to downscale lending operations towards small and micro loans. Currently counterpart banks in this program include Eksim, Kulska and Komercijalna banks. While this approach has been successful in other CIS countries, the program is still too new to demonstrate results.
- Many CRDA clients have developed thriving enterprises that are constrained due to lack of access to additional capital. There may be opportunities to leverage the impact of the CRDA program by coordinating the geographic and sectoral focus of credit programs.

- The constraints to expansion vary by the institution. Opportunity Bank, AgroInvest and MDF all face capital constraints that impede their growth. ProCredit, by contrast, has a significant capital base to draw on, and its growth will only be limited by its capacity to manage its expansion.
- Several microfinance organizations have formed a working group to address regulatory and policy constraints. The lack of interest on the part of the government has led to a loss of momentum and little desire on their part to commit further resources.

Business Services

- The Serbia Investment and Export Promotion Agency (SIEPA) seems to be getting increased government support, but it received mixed reviews by private sector representatives interviewed.

SIEPA was created with World Bank support four years ago and appears to be a relatively well functioning agency, although not all persons in the private sector interviewed agreed with that assessment. Its Director is a former employee of the SEDP Project and it has received considerable technical and other support from that project. An interview with the Director and the Export Promotion Advisor revealed capable staff who understands the constraints on Serbia's exports, are realistic about the competitiveness of Serbian products and services, and have a good program to support Serbian businesses interested in developing exports. Their support for FDI is less clear and this could be due to their limited impact on removing obstacles to FDI. In any case, the agency is now getting increased support from the European Agency for Reconstruction (EAR) and this should help to improve the agency's prospects for helping Serbian businesses develop exports.

- Business Associations in Serbia are limited in number and require nurturing

The American Chamber of Commerce (AmCham) was established in early 2002 with 23 founding members. It now has 150 member companies that employ over 130,000 people and which have invested about \$1.36 billion in Serbia. Over 60% of members are U.S. companies, including some USAID contractors and NGOs. The Executive Director estimated that about 20% of the membership was local companies. He told the Team that small Serbian businesses were discouraged from joining because AmCham management doesn't want small Serbian businesses bothering large international company executives during meetings. Membership fees range from \$400 for nonprofits to \$2000 for corporate membership. He mentioned collaboration with the SEDP Project on mobilizing support against a proposed negative change in the labor law. That support led to the government dropping the proposed change. He said that the two biggest successes of AmCham over the past two years were convincing the government to drop an increase in taxes of tobacco products and the passage of an intellectual property law at the State Union level.

The Foreign Investor's Council seems to be serving the foreign investors well and about 80% of AmCham's membership are also members of the FIC. The FIC prepared a "White Book – a Proposal for improvement of the investment climate in Serbia" that is quite good and comprehensive. Its emphasis is on larger investments and particularly foreign investment so it is less relevant to SME and microenterprises.

The Union of Employers is another business association in Serbia and has collaborated with the AmCham and the FIC on some issues. Our understanding is that the Union of Employers was the most promising general business association in Serbia a year ago but the association fragmented leaving the business community in disarray over who is the legitimate successor. The Government helped to exaggerate this confusion by providing support to a group who was less critical of government activities. The other group that came from the original Union was active in advocating against the new Labor Law and several others and so created enemies within the Serbian Government. However, their leadership and real membership support is also dubious.

The Chamber of Commerce of Serbia is generally seen as ineffective. It is not voluntary since contributions are mandatory. Without this "tax" the Chamber would undoubtedly not exist. Under the new leadership of Slobodan Milosavljevic it is hoped that it will reform and actually serve its members. However, business people view it as highly politicized and a poor performer. Still, the Chamber has the best network in Serbia and maintains contact with many companies. The platform is there. The SEDP has tried to work with them and while the Serbian Chamber of Commerce may have good intention, SEDP has met with little action and few results.

- The Southeast Europe Enterprise Development (SEED) project has had some significant impact in developing the leasing law for Serbia and some limited success in developing a consulting services market, but its future funding is in question

The SEED development facility, financed by the IFC, has been providing a range of services to SMEs since its inception five years ago. SEED is losing its core funding from the IFC and will provide only services that are funded by other donors on a demand basis. SEED charges business clients for its local costs, but its overall operations have been heavily subsidized by the IFC. The quality of SEED's services to SMEs seems to have been high; however, it will be interesting to see what happens to SEED now that its core funding from the IFC is ending.

- The network of SME development agencies continues to receive donor support, but will have difficulties with financial sustainability

The Team met with the regional agency for SME development for Belgrade and environs. It is part of a national network established by the government with donor support. Fifteen (15) regional centers are located in Serbia and some have subcenters. Seven were financed by the European Union and two by GTZ. Others had national and local government funding. Many of these centers are in financial trouble since donor support dropped off. More EU funding is anticipated, but without donor or local government

subsidies, these business centers will most likely disappear. Training and consulting services are provided by the agencies to SMEs with some cost recovery from clients. These agencies are typical of the failed business center approach to SME services tried in other countries in Eastern Europe and the FSU.

- Recent efforts to coordinate agricultural development activities by SEDP and the CRDA implementers and USDA have resulted in collaborative problem-solving in sanitary and phyto-sanitary certification.

The government of Serbia and Montenegro recognize the importance of meeting international trade standards for health and safety. The Ministry of Agriculture is willing to fund up to 80% of the certification costs and 60% of the training costs to meet sanitary and phyto-sanitary requirements. The newly formed Agricultural Committee at the Embassy along with the Agricultural Attaché is coordinating with the Ministry to help facilitate certification of key agricultural exports and exporters.

- Exports are low due to lack of understanding by Serbian entrepreneurs of quality and other factors that would make their products competitive in other markets

The Team was constantly reminded by various parties interviewed that Serbian businesspersons do not have a good understanding of international quality standards and how to market their products and services in other countries. Not only do they fail to comprehend the challenges of globalization and competition from Asian countries, they have not kept up with changes in neighboring countries that are succeeding in trade and exports, such as Bulgaria, Romania and Slovenia. Many of the businesses succeeding in SAM include businesses with Slovenian investors and managers. The SEDP Project is working closely with some enterprises to improve product quality and knowledge of market access with their greatest success in the fruits and berries sector as well as apparel and tourism.

CONCLUSIONS

Policy/Regulatory Environment

- A well-functioning macro and microeconomic environment is essential for economic growth. The current situation militates toward programs assisting in the development of greater public/private sector dialogue on reform agendas.
- A major barrier to economic growth is the lack of investment in businesses, particularly agriculture.
- While improvements in the national policy environment are essential, improvements at the local level is just as important to promote local enterprise development and investment.

- The CRDA program provides useful models for integrating economic development and improvements in municipal governance that could provide a framework for future Mission programming.

Finance

- The policy environment is not a barrier to the viability of microfinance institutions.
- The high cost of credit is driven, in part, by a poor institutional framework for financial sector development. The following policy issues affect the risk assessments of banks, and their resolution would reduce the risk premium that drives interest rates higher.
 - Bankruptcy code
 - Law on Registration
 - NBS reserve policies
 - 20% tax on interest rates in excess of 12%
- The high reserve requirements, the requirement for direct provisioning against all lending below 5000 euro, and the above identified tax on interest rates above 12% all serve to increase the costs of lending, and reducing the availability of capital for banks to lend. As a result, less credit is available and the cost of credit is higher for SME lending.
- While there are a number of financial institutions providing financial services to SMEs and microenterprises, the level is still insufficient to achieve moderate levels of overall economic growth
- Given that there are good microfinance institutions in Serbia, the greatest constraint to increasing the availability of credit is the limited capital available to most of these institutions.
- Institutions currently providing microfinance services in Serbia follow sound models that can support significant growth in access to credit for small enterprises and the poor.
- While some controversy regarding grants to private enterprises exists, it appears that some CRDA grants to enterprises have achieved substantial enterprise impact and broader community development.

Business Services

- The current focus of the SEDP project is on the right track and is achieving some gains in selected sectors (e.g., fruit and berries and some limited success in tourism, apparel and export development support activities).
- While there are many enterprises working in the agricultural sector (as noted above and particularly with SEDP, these enterprises do not have unique business needs that would require a different approach from non-agricultural enterprises. Of course, agricultural

enterprises must deal with perishability, food safety standards and international sanitary and phytosanitary standards (SPS), particularly if the product is for export. These aspects require unique technical approaches and solutions but generally the enterprises operate as a business and, for example, SEDP is working with them as businesses.

RECOMMENDATIONS

Overall Principles for Economic Growth

Since the objective of the Mission and the USG is to create an environment that has more opportunities for SMEs and microenterprises to increase incomes and employment opportunities, a number of principles should guide the development of the program. They are described below.

- With SAM having been delayed in going through its transition to a market economy, the future privatization process will require restructuring (at best) or the disappearance of enterprises in order for viable private enterprises to develop. This implies large groups of people being laid off and unemployment rising in the immediate term. Mission strategy should focus on enterprise growth to promote sustainable employment through the development of firms of all sizes that are providing market-driven products and services.
- SMEs need larger firms in the economy to drive their growth. Furthermore, larger, international firms bring new technology and improved production/management techniques to SAM to help move local firms into the global economy. Thus, rather than focusing on SMEs or microenterprises, Mission strategy should encourage the development of firms along the entire value chain, from top to bottom. Practical assistance to firms and clusters of firms might focus on SMEs and microenterprises, but support to develop larger firms should be included in the strategy. At a minimum this means supporting a policy/regulatory environment that benefits firms at all levels. Forums, conferences, industry strategy development, dialogue with government should be such that firms at all levels are encouraged to participate.
- Most people are not entrepreneurs and would prefer to be employees. Programs that try to turn unemployed persons into entrepreneurs on a large scale are bound to fail. While support to survivalist microenterprises is important as a poverty alleviation strategy, survivalist microenterprises will not drive economic growth in a country. Rather, Mission strategy should focus on both promoting both domestic and foreign investment to bring in larger (and where possible international) companies and promote the growth of domestic SMEs to increase employment. Linking larger domestic and foreign firms with local SMEs and microenterprises is a more viable strategy to increase employment.
- Support to cluster development should be based on market analysis such as that being done by SEDP in Serbia and the competitiveness project in Montenegro. The latter is conducting a market analysis of potential for Montenegro products in regional trade.

This type of analysis is important for ascertaining potential increased regional trade. Recent competitiveness-oriented projects in the Balkan region have tended to identify the same clusters (or subsectors) for support, oftentimes listed in the RFP. Missions need to allow for support to clusters or subsectors that provide “windows of opportunity,” i.e., when a particular firm or group of firms is identified as having success and has growth potential but haven’t been part of the prescribed set of clusters for a project.

- Mission strategy on enterprise finance options should primarily seek to develop financial institutions rather than support enterprises directly. A case can be made for providing direct enterprise support through grants (e.g., through the CRDA project) when a social purpose is being served, but subsidized credit is rarely an effective medium or long-term strategy.
- Efforts to improve the policy environment for financial institutions are very important.

Policy/Regulatory Environment

The Mission should continue to support policy reforms through:

- Support to reformers in government.
- Support to business associations and other private sector entities with a focus on developing mechanisms for public/private sector dialogue.
- Support to think tanks to develop their capacity to improve data collection and conduct analysis that would integrated into the public/private sector dialogue process.
- Continued support to the court system and the development of commercial law.
- Increased emphasis upon integrating agricultural policy concerns into the WTO and EU accession agendas.
- Use the cluster/sector development approach to identify critical constraints to sector development in order to build a constituency for reforms in that sector.
- Encourage public/private sector dialogue and collaboration in industry strategy formulation (e.g., ICT in Bulgaria)
- Conduct some study tours to other countries in the region utilizing best practices in enterprise development

Finance

- Efforts to increase access to financial services will have the greatest impact on Mission results if directed towards sectors and geographic areas what are also the focus of other Mission activities. Given resource limitations, activities in the financial sector should

leverage the impact of other Mission activities. Microfinance activities should be coordinated geographically and sectorally to address financial constraints at the base of targeted sectors and value chains.

- Mission support to individual microfinance institutions should be based the institution's ability to reach microenterprises that do not have access to financial services from other sources and that are committed to highly efficient operations.
- USAID should support credit enhancements through the DCA to increase credit availability to agricultural production and processing through value chain participants. DCA could be used to increase commercial bank participation in particular sectors or to increase on-lending to other institutions that require capital to increase their provision of financial services to micro, small and medium enterprises.
- The Mission should identify opportunities to work with commercial banks, either through credit enhancement or technical assistance, that are seeking to increase their services to those market segments with limited or no access to financial services.
- The Mission should be cautious in granting funds to institutions that are seeking to penetrate markets already being served by other commercial institutions.
- USAID should support the proposed Balkan Equity Fund Initiative to improve equity capital availability.

Business Services

- USAID should continue to provide support to both private and public sector institutions (e.g., SEDP support to SIEPA) that are focusing on improving the investment climate.
- The implementation of economic growth and municipal development programs should complement each other to the greatest extent possible through active geographic and technical coordination.
- Enterprise development support should continue to focus on enterprises in targeted sectors with good potential for growth. However, projects should not be precluded from assisting enterprises in other sectors if their prospects for growth are high.
- Project implementers should utilize SME regional agencies when feasible, but there is no need to provide any USAID support, since there is sufficient funding from other donors.

MONTENEGRO

BACKGROUND

The USAID Montenegro Annual Report FY2005 states that Montenegro is disadvantaged by a small market with difficult access. Stimulating the private sector and attracting much-needed foreign investment remain the main challenges going forward. Most factors affecting development, though well within Montenegro's control, will require sustained political will to take difficult decisions. Private-sector development requires simultaneous progress on a number of different fronts. Now that a solid set of business laws are in place, implementation of judicial reform is critical to ensuring that these laws are uniformly enforced in a fair and effective manner. Labor markets maintain serious rigidities, with several layers of collective bargaining clouding and restricting employer rights. Infrastructure continues to be poor and badly under-financed, with the Government reluctant to charge cost-recovery rates or enforce collections at any level. Bank supervision has improved radically over the past few years, but continued mistrust of banks contributes to relatively low levels of deposits, despite strong growth, which in turn limits credit available and keeps interest rates high. Finally, despite vast improvement in the business registration process, rigidities, and discretionary applications of regulations remain. The ability and willingness of the Government to tackle these issues rests on two main pillars: social cost and the political will to tackle corruption.

A paper prepared by the Center for Entrepreneurship and Economic Development (CEED) in Montenegro in 2004 stated that there were nearly 25,000 businesses registered in Montenegro and that nearly 97% were considered SMEs (less than 250 employees). Over 13,000 of these businesses are registered as "Entrepreneur" and can probably be assumed to be microenterprises. The private sector employed more than 45,000 persons. 40% of these SMEs are registered in Podgorica. The 2003 Montenegro Transition Report, prepared by the Institute for Strategic Studies and Prognoses (ISSP) in Podgorica, cited a report by CEED that "privatization was inciting the formation and expansion of new enterprises. For example, of the 300 most profitable enterprises in Montenegro, 83% are private and of the 300 enterprises having the best credit rating, 74% are private.

The Montenegro government does not appear to have a specific strategy for SME development, it does recognize the importance of SMEs and has taken steps both to make a better enabling environment for SMEs as well as to providing support for SME development through the SME Development Agency (SMEDA) and promoting private sector institutions to provide services to SMEs. The goal of SMEDA's director is to have SMEs providing over 50% of GDP. This appears to be a reasonable objective and one that could be met in the next few years. SME capacity in Montenegro has much room for growth, especially outside of Podgorica. The tourism industry in most countries tends to be dominated by SMEs, with a few large enterprises anchoring the economic growth of the sector, so Montenegrin SMEs can grow as that sector grows. The work done under the CRDA program has provided support to fledgling SMEs and could provide the basis for additional USAID support in future years, albeit through other, more traditional forms of SME support mechanisms.

FINDINGS

Policy/Regulatory Environment

- The policy and legal environment is considerably advanced, but more work needs to be done and the implementation of the new laws and regulations is still problematic

Interviews with representatives of the Ministry of the Economy stated that the economic reform agenda started in 2002 and will last until 2005. The aim of the agenda is to increase GDP and decrease inflation. They asserted that unemployment decreased by 15,000 between 2003 and 2004 and that various institutes have estimated a decrease in the gray economy from 30% to 20%. While the government decreased the employment tax by 10% last year, the IMF would prefer keeping the tax higher until the budget is balanced. Their program for SME development began in 2001 and the first phase is to get an accurate assessment of employment in companies. They believe that in order to increase Foreign Direct Investment, the most important factor is stability, but that the small domestic economy is a hindrance. It is clear that the potential for exports is a critical factor if FDI and the Montenegro economy are to develop.

The Montenegro Agency for SME Development believes that improvement in the enabling environment is necessary if the Montenegro economy is to grow. They have worked to simplify business registration. It currently takes 4 days and one Euro to register a business. An OECD study allegedly states that Montenegro's business registration procedures are some of the best in the world. The goal of the government is to reduce the employment tax by 50%, but the IMF believes that this is too much at the current time due to other concerns. They are also working on licensing issues and have received assistance from USAID on this.

Representatives of the Ministry of Finance and the Prime Minister's Office stated that they have received assistance from USAID in micro-economic reform and that they would like to receive more, in coordination with the European Agency for Reconstruction (EAR). They mentioned the road infrastructure and electricity generation as constraints on development. The Government of Montenegro would like to use privatization funds for infrastructure development, but the IMF would prefer to use them for other purposes. A consultant on ICT to the Ministry of Finance stated that the ICT infrastructure is very undeveloped in Montenegro, except for Podgorica and along the coast. He expects it to get better when the state-owned telecom agency is privatized. The Ministry of Finance would like to bring the informal sector into the formal economy and the agencies responsible for collecting revenues are addressing informality issues. They said that the Montenegro Business Alliance and the Union of Employers are working with the GOM on issues related to the informal economy. They also believe that workforce development, including increased language skills, is important to improve the economy.

- USAID activities to promote local think tanks, business association advocacy, consulting services and leasing have resulted in substantial local capacity in these areas

The Team met with the MBA and the Institute for Strategic Studies and Prognoses (ISSP). Both have received support from USAID (for the MBA mainly through CIPE) and have produced some impressive documents dealing with economic reform. MBA has some 1400+ members and has conducted a number of roundtables and conferences on economic reform issues. A meeting with these organizations was arranged by CIPE, along with CEED and CARA.

The Team met with Veslin Vukotic, a professor at the University of Montenegro who has had considerable impact on economic reform issues, and Peter Ivanovic, who has played a pivotal role in the MBA, ISSP and the Center for Entrepreneurship and Economic Development (CEED). They claimed that the economy of Montenegro is showing promise and that the institutional framework is on the right track. They said that changing the currency to the Euro has very practical effects on the economy. They felt that the main problem for business development was changing people's attitudes toward the private sector. They felt that USAID needs to focus its efforts on administrative reform. They said that the GOM needs fewer government agencies and that the European Union is responsible for establishing more than are necessary. They are part of the Commission for Economic Freedom, an organization composed of about 25 people from government, the private sector and foreign advisors. It has been responsible for promoting various economic reforms. They said that the general population now has a good idea why reform is necessary, but the implementation of reforms is the key obstacle. They view the work by the MBA as critical since it seeks true economic reform as opposed to some businesses that seek government influence only to improve their particular business interests. They believe that a program such as CCASA in Serbia could help to improve the court system in Montenegro, especially to improve the human capital in the court system.

- Agriculture plays a much smaller role in the Montenegro economy but has opportunities for niche markets.

Given the topology and land use patterns in Montenegro agriculture is limited to a few areas. However, opportunities exist for the production of vegetables and produce and perhaps meat for the tourist market. Montenegro also has potential for wild herb and fruit, and the GTZ organization is currently working with SMEs to develop this market. This is also an area for tourism potential as tourists come during various seasons to pick fruits, herbs and mushrooms. The GTZ program has developed manuals and training materials to protect the environment and identify specific herbs and how to pick and handle them.

Finance

- The legal environment is more favorable to non-bank microfinance institutions than in Serbia.

The “Decision on Microfinance Institution” (2002) provides the legal basis for the operation of microfinance institutions. It permits loans, leasing and consulting services. Initial loans to individuals cannot exceed 3000 euro and can increase to 8000 euro. Initial loans to businesses cannot exceed 5000 euro and then can increase to 20,000 euro.

- The financial sector is weighted with consumer credit and there are fears that the high level of credit will disrupt the economy.

This perception was similar to that in Serbia and was expressed by a number of interviewees from the financial sector. The IMF is driving this issue in Montenegro as well as in Serbia and is using its influence to limit the availability of consumer credit in both countries.

- The Montenegro Bank appears to be well managed and has provided considerable credit to both SMEs and other enterprises

The Deputy Managing Director of Montenegro Bank stated that the bank has plenty of liquidity, largely due to its Slovenian investors. They have been very active in lending since this state-owned bank was purchased by Nova Ljubljanska Bank of Slovenia about two years ago. Being the largest bank in Montenegro, it has a network of thirteen branch banks throughout the country with about 250 employees. The bank owns about a half of the bonds issued by the State Treasury. They have assets of about Euro 70 million, with only about Euro 6 million in savings, since people still don't trust banks with their savings. About two thirds of savings are in long-term instruments (1-3 years) and the bank pays up to 4.5% for deposits of over one year. Montenegro Bank has just bought Euromarket Bank, with assets of about Euro 40 million and will use Euromarket's VISA authority to offer debit cards in the next months.

The bank has taken an aggressive strategy toward lending and has lent Euro 55 million in the past two years in consumer and enterprise credit. Over Euro 30 million has been lent to enterprises, with more than half of that to SMEs. The breakdown for distribution of the loans (in Euros) is about 17 million in trade, 5 million in tourism and catering, 4 million in production, 3 million in construction, 2 million in transport and 1 million in agribusiness. Terms vary from 10% interest for a line of credit up to 12 months, to export credit at 7.5% for up to 6 months, to equipment finance at 7.5% for up to 96 months, to leasing at 8.5% for up to 48 months, to real property loans at 8.5% for up to 96 months. These rates are for creditors in Category A (the most secure creditors), with an additional 1.25% for creditors in Category B. When asked how the bank can obtain accurate financial information from enterprises, he said that it is getting easier to obtain same. They have offered leasing and will be establishing a separate leasing firm in the next year. He said that the interest rates charged by other banks is higher than those charged by Montenegro Bank and he expects competition will force those rates down. Montenegro Bank can provide lower rates because it has access to cheaper funds from its Slovenian investors. He feels that tourism is the main generator of income for the country and that their tourism loans are mainly for the larger hotels. Food processing is a promising industry as well.

- There are several well-managed microfinance organizations and the SME segment is becoming increasingly competitive

Opportunity Bank is the only formal bank involved in microfinance lending in Montenegro. It has been rated by Microfinanza Rating (a reliable microfinance institution rating service) as having a strong capacity to meet its financial obligations, and stable and unlikely to be adversely affected by foreseeable events. This is a very good rating for a microfinance institution. OB has approximately 7000 loans in its portfolio.

AgroInvest (World Vision) has a unified operation for Serbia and Montenegro. It has approximately 8000 loans in Montenegro, with an average loan size of approximately 1500 euro. AgroInvest has been rated A- by Planet Rating, which rates microfinance institutions for potential investors.

Alter Modus is a well run, independent microfinance institution. They have 4300 clients and an average loan size of approximately 1000 euro. Although Alter Modus is funded predominantly using borrowed funds, it still operates at a profit.

CIPE provided assistance to help establish the Montenegro Leasing and Finance Company as the first leasing company in Montenegro. Its founders are from various countries in the region and it signed about twenty leasing contracts this past year.

The CRDA projects are also providing finance via grants and are providing assistance on many community development-related economic development activities. The Team met with IRD and CHF to discuss their activities in Montenegro. While the agreement for the extension of these activities states that 50% of funds are to go for economic growth activities, much of their work to date has been related to infrastructure development, environment awareness and actions, and civic participation.

The Employment Agency of Montenegro (EAM) provides subsidized credit under two programs – one to support self-employment and the other to provide support to employment and the development of tourism and agriculture. Six banks manage the credit lines and the GOM funds the difference between the subsidized rates, ranging from 3 - 7%, and the market rates charged by banks. 650 projects have been financed for a total of Euro 9.6 million. Of the credit lines, five are for enhancing employment and four are for tourism and five for agriculture. The self-employment credits carry an interest rate of 3% with a one-year grace period and the average loan size is about Euro 500. The staff person interviewed was reluctant to give any statistics about loan repayments.

- While there is some investment in local enterprises, there is very limited FDI.

A briefing with USAID revealed that there is considerable Russian investment in Montenegro, but that there is no American investment there. There has been some investment by the Italians and Slovenians.

Business Services

- Business consulting services are limited with only a few active qualified firms

The business consulting market appears to be dominated by CEED. CEED was set up, with USAID support via CIPE, to provide training to entrepreneurs, but has now established a consulting practice as well. They have five offices throughout the country with a total of twenty-one employees. They hire pollsters to conduct surveys and have twelve consultants in their roster. They claim to be nearly financially self-sustainable, but only time will tell if this is true.

An interview with the EAR revealed that they plan to provide funds to other groups to try to develop the business services market. They are managing two new programs – one to provide business advisory services (BAS) to small enterprises and the other will provide turn-around management (TAM) services to medium-sized enterprises. They expect TAM to utilize more expatriate consultants than BAS and focus on exports. Much of EAR's work in enterprise development has been related to privatization. BAS and TAM will be managed by the EBRD and will be a two-year project funded at Euro 1.4 million.

The SME Development Agency (SMEDA) provides consulting services as well through nine local business centers, but the Team was told that it mainly uses private sector firms (about 30 firms are listed on their roster) and individuals to provide consulting and training services. SMEDA was established by Parliament and began operations in February 2001. It has four functions – 1) developing institutions providing support to SMEs, 2) improving the enabling environment, 3) education and training of SMEs, and 4) providing finance to SMEs. The Director believes that education and training is the most important of the four and that finance should be provided through commercial and specialized finance institutions, rather than through state agencies. SMEDA's objective is to raise the level of competence in enterprises to enhance their competitiveness, both inside and outside Montenegro. SMEDA has helped to establish entrepreneur clubs in primary schools. (There is a Junior Achievement Program in Montenegro, but it works only in secondary schools.) SMEDA's work in the enabling environment is mentioned in the Policy/Regulatory Environment section above. Their primary focus has been on training and consulting services development. The Director stated that privatization of SMEs in Montenegro has not been a problem. He said that there were only 36 private enterprises in Montenegro in 1989, whereas there were over 24,000 in 2004, with a contribution to GDP of 37.2%. His goal is to have SMEs contribute 50% of GDP. A Euro Information Center (EIC) is housed at SMEDA with EU support. The EIC network started in 1987 and now has over 300 members, mainly in European countries. The EIC in Montenegro provides support to enterprises on exports to European countries (taxes, export restrictions and procedures, agents, etc.). It serves about twenty clients per month.

- Aside from heavy industry most sectors contribute low levels of value added.

Interviews with various persons in both the public and private sectors reported the lack of value added to products in Montenegro. This creates problems in generating exports and is a particular constraint on tourism.

- Infrastructure is a major constraint both in the north and on the coast.

Numerous parties mentioned the poor infrastructure in the north and on the coast. Secondary roads are in bad repair and the coast suffers from electricity and water shortages and sewage problems. The CRDA projects have provided some funds for infrastructure, much greater efforts will be required by the GOM, other donors and the private sector to resolve these problems.

- Tourism and agriculture have the greatest potential for growth, but with substantial hurdles to be overcome

The USAID Competitiveness Project is working mainly in three areas – tourism, agribusiness and wood products. The consultants from this project expect that tourism and agribusiness will be more beneficial than wood products since the wood sector has considerable structural problems with state-owned enterprises controlling too much of the raw materials market. Tourism is driven by the coast and the season is relatively short. Complaints of hotels and restaurants being closed much of the year has resulted in a shortage of tourists during the “off season.” The limited port facilities also impact on cruise traffic. Other tourist markets such as Turkey, Egypt and Tunisia (as well as Croatia to the North) have impacted the younger tourist market since those countries now compete directly with Montenegro for tourists from the Balkans. A cluster approach is being taken to develop the tourism industry. (The Team noticed a brochure at the Eminent Hotel that discussed an association of Montenegro hotels founded with German support.) The Chief of Party of the Competitiveness Project said that there are some good agribusiness prospects with linkages to the tourism sector. The project is not using a cluster approach in this sector as much. The project has conducted a market survey of the need for various agriculture and food products in the Balkan region and has participated in trade fairs, such as the Gulf Food Fair 2005 in Dubai. Fruit juice, dairy products, olive oil and honey were mentioned as having good prospects. This project should help to develop direct business-to-business services as well.

In general, the tourism and agriculture sectors in Montenegro compete against neighboring countries with equally significant potential. For example, the tourism industry competes head to head against the Croatian coast. Quality upgrading, improved services and other necessary aspects to success in higher value tourism will require the successful operation of both large and small enterprises in each sector.

The Center for Applied Research and Analysis (CARA) has analyzed different sectors in Montenegro and conducted roundtable discussions on same. Sectors analyzed include agriculture, tourism, trade and maritime.

A GTZ project is working with meat production, wild fruits and forest herbs, in conjunction with SMEDA. The first phase in 2003-2004 focused on the micro level to improve the variety and quality of products. The second phase began in 2005 and will concentrate on linking these products with the tourist market.

CRDA project implementers are also charged with working in the tourism, agribusiness and wood sectors under the amendment to their agreement, as do a number of other donor-funded projects in Montenegro.

CONCLUSIONS

Policy/Regulatory Environment

- Although the Commission for Economic Freedom is serving as a body to promote public/private sector dialogue, there is need to strengthen the advocacy role of business associations and to develop other mechanisms for private sector input into the policy reform process
- The local think tanks and business associations interviewed are at a relatively high level of development and USAID's work with these organizations has clearly been successful. The Assessment Team was impressed with the quality of the people working in these organizations and their capacity.

Finance

- Local investors appear to have a very short-term horizon for investment returns.
- The performance of the microfinance organizations indicates that there is substantial unmet demand for financial services for micro and small enterprises.
- Gaps in the availability of financial services has significant potential to slow the development of high-potential sectors.
- The availability of financial services is critical to developing small and micro enterprises that provide services and products necessary to the competitiveness of high potential sectors. For example, a successful fruit export industry requires reliable transit, packing materials, labeling, availability of inputs, etc. Many of these inputs and services would be provided by micro and small enterprises in Montenegro.
- The SME credit market appears to be loosening and interest rates appear to be coming down.
- A number of solid microfinance and banking institutions exist that could be solid partners with USAID in reaching program objectives

- Given the high general demand for credit in Montenegro, and the low relative availability, it is critical that the highest potential sectors are able to make necessary investments to retain and increase their productivity and competitiveness. Without donor support and incentives, financial institutions may not develop new and innovative financial instruments appropriate to these sectors (for example, Alter Modus has developed a tourism loan where the repayment is timed to the tourism high season) There are a number of ways that agriculture and tourism could be a focus of future financial sector programs; microfinance, DCA, and other programs can have a significant impact in leveraging the potential and current momentum of particular sub-sectors.

Business Services

- The small domestic market in Montenegro provides limited opportunities to achieve economies of scale for any large scale productive enterprises unless they are export oriented
- High labor rates, high employment costs and high cost of inputs place additional limits on opportunities for competitive local products
- There is considerable potential for the growth of the local food processing industry related to tourism development on the coast as well as potential for organic food production in the North
- Niche tourism (e.g., adventure tourism and agro tourism) opportunities exist in the North
- The business services market is substantially underdeveloped, but with some strong existing entities and EAR programs will attempt to increase capacity and encourage new entrants in the field
- The SME Agency appears to have some promise and is engaging in good practices in terms of promoting the private sector as service providers as well as promoting entrepreneurship education at the elementary school level
- Although the Master Plan for Tourism Development is sound, the tourism industry, itself, lacks an understanding of its competition, target markets and its strengths and weaknesses
- Workforce development is a critical component of an effective strategy to develop the tourism and niche agriculture sectors

RECOMMENDATIONS

Policy/Regulatory Environment

- The Mission should continue to support policy reforms through

- Promotion of transparency in public procurements
- Continued support to business associations and other private sector entities to develop mechanisms for public/private sector dialogue
- Continued support to existing think tanks to develop their capacity to conduct analysis that would be integrated into the public/private sector dialogue process
- Increased emphasis upon integrating agricultural policy concerns into the WTO and EU accession agendas
- Use the cluster/sector development approach to identify critical constraints to tourism and agriculture development in order to build a constituency for reforms in that sector

Finance

- USAID support for improving the investment climate in Montenegro should be focused on tourism and agriculture
- High value added niche agriculture and tourism could serve as drivers for small and microenterprise development and their successful participation will require upgrading that will increase demand for financial services.
- USAID should support credit enhancements through the DCA to increase credit availability for tourism and agricultural production and processing through value chain participants
- USAID should support the proposed South Balkan Fund proposal from the Small Enterprise Assistance Funds to improve equity capital availability in the region.

Business Services

- USAID should provide assistance to the tourism sector (in conjunction with other donors, e.g., GTZ) to implement the approved tourism Master plan for Montenegro with a focus on marketing and improved infrastructure and services.
- The Competitiveness Project has just begun, but this is the appropriate approach to the development of business services.
- USAID should find ways to work with the Montenegro SME Development Agency, which appears to have more promise than the equivalent agencies in Serbia. The EAR also will be supporting business services development more in the future and USAID should coordinate its approach with them.